Supreme Court, U.S.
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No. 98-___ OFFICE OF THE ...

In The

Supreme Court of the United States

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

PETITION FOR A WRIT OF CERTIORARI

Drew S. Days III
127 Wall Street
New Haven, CT 06520
(203) 432-4948

Walter Hellerstein
University of Georgia Law School
Herty Drive
Athens, GA 30602
(706) 542-5175

Charles J. Moll III
(*Counsel of Record*)
Edwin P. Antolin
Morrison & Foerster LLP
425 Market Street
San Francisco, CA 94105
(415) 268-6497

Fred O. Marcus
Horwood, Marcus & Berk, Chartered
333 West Wacker Drive, Suite 2800
Chicago, IL 60606
(312) 606-3210

Counsel for Petitioner

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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QUESTIONS PRESENTED

1. Under the Commerce and Due Process Clauses, a State may not tax the dividends that a nondomiciliary corporation receives from its nonunitary subsidiaries. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F. W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). California law nevertheless requires that a nondomiciliary corporation reduce its deductible net interest expense – and thereby increase its apportionable income subject to tax – by the amount of such exempt dividends. Moreover, this requirement applies even when the disallowed interest expense is unrelated to the production of the exempt dividend income. The question presented is:

> Whether a State may tax constitutionally exempt income under the guise of denying a deduction for expenses in an amount equal to such income when there is no evidence that the expenses relate to the production of the exempt income?

2. Whether a state tax discriminates against interstate commerce in violation of the Commerce Clause by disallowing an otherwise deductible expense, thereby increasing California taxable income, solely because the corporation is not domiciled in the State or does not have subsidiaries that engage in taxable in-state activity?

LIST OF PARTIES

The parties are as stated in the caption. In the courts below, the petitioner was referred to as Hunt-Wesson, Inc., successor in interest to Beatrice Companies, Inc., and as Hunt-Wesson, Inc., formerly known as Beatrice/Hunt-Wesson, a successor by merger with Beatrice Company, formerly known as CagSub, Inc., a successor in interest to Beatrice Companies, Inc., formerly known as Beatrice Foods Company.

RULE 29.6 STATEMENT

Hunt-Wesson, Inc. is a wholly owned subsidiary of ConAgra, Inc. Its non-wholly-owned subsidiaries are ConAgra Brands, Inc. and ConAgra Limited.

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PETITION FOR A WRIT OF CERTIORARI

Hunt-Wesson, Inc. respectfully petitions for a writ of certiorari to review the judgment of the Court of Appeal of the State of California, First Appellate District, Division Three, in this case.

OPINIONS BELOW

The Opinion of the Court of Appeal (App. 1a-13a) is not officially reported. The judgment and statement of the Superior Court of California, City and County of San Francisco (App. 14a-34a), is not officially reported. The California Supreme Court's denial of Hunt-Wesson's petition for review (App. 43a) is not officially reported.

JURISDICTION

The judgment of the Court of Appeal was entered on December 11, 1998. The Supreme Court of California denied Hunt-Wesson's petition for review on March 24, 1999. App. 43a. The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The Due Process Clause of the Fourteenth Amendment to the United States Constitution, U.S. Const.

amend. XIV, § 1, provides: "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

Relevant portions of the California statutes are set forth at App. 35a-38a.

STATEMENT

California denies nondomiciliary corporations a deduction – and thereby increases their California taxable income – in a manner that offends bedrock principles of constitutional law. It does so through three discrete and equally indefensible rules that disallow a deduction for interest expense that is otherwise deductible.[1]

First, California arbitrarily allocates all of a nondomiciliary corporation's net interest expense to income that, under the Commerce and Due Process Clauses, California may not tax. California makes this allocation, and thus denies a deduction for the interest expense, even when the interest expense bears no relationship to the constitutionally exempt income. Rather, California's denial of a deduction for interest expense is due solely to the receipt of constitutionally exempt income. As a consequence, California increases nondomiciliary corporations' taxable income base by an amount equal to the exempt income, effectively taxing exempt income in violation of controlling decisions of this Court. *See, e.g., National Life*

[1] California law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a).

Ins. Co. v. United States, 277 U.S. 508, 519 (1928) ("[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free").

Second, California permits domiciliary corporations, but not nondomiciliary corporations, to reduce their taxable income by interest expense deductions to the extent that the corporation receives dividends from nonunitary corporations. Since the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation,[2] it violates the cardinal principle of this Court's Commerce Clause jurisprudence barring taxes that facially discriminate in favor of in-state over out-of-state entities. *See, e.g., South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999) (striking down franchise tax that favored domestic over foreign corporations).

Third, there is an exception to the arbitrary rule of interest expense allowance described above, but that exception is unconstitutional as well. California does not require a nondomiciliary corporation to reduce its interest expense deduction insofar as it receives dividends from nonunitary corporations that engage in taxable activity in California. But this limited exception to the unconstitutional rule of interest expense deduction disallowance discriminates on its face against interstate commerce by conditioning a tax benefit (the deductibility of interest expense) upon the extent of a corporation's in-state activity. It therefore runs headlong into decisions of

[2] Respondent Franchise Tax Board acknowledged that the provision at issue here operates to "increase taxes on foreign corporations while reducing those of domestic corporations." *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 554 (1972).

this Court that have condemned indistinguishable taxing schemes under the Commerce Clause. *See, e.g., Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) (invalidating intangible property tax exemption that varied with extent of corporation's business activity in the State).

The decision below sustaining California's arbitrary and discriminatory disallowance of interest expense is incompatible with controlling decisions of this Court. If left undisturbed, it will provide a roadmap for evasion of the constitutional restraints on state taxation embedded in this Court's doctrine. By the simple expedient of "denying a deduction" equal to a taxpayer's constitutionally exempt income, even when such expenses are unrelated to the production of such income, States will effectively be able to tax the exempt income in violation of constitutional constraints. Review of the decision below, which raises issues also raised in *F. W. Woolworth Co. and Kinney Shoe Corp. v. Franchise Tax Board*, No. 98-1967 (Petition for Writ of Certiorari filed June 7, 1999), is plainly warranted.

1. Beatrice's Business

The facts of the case are not in dispute. Petitioner Hunt-Wesson, Inc. is the successor in interest to the Beatrice Companies, Inc. ("Beatrice"), the original taxpayer in this case. Beatrice was a Delaware corporation with its commercial domicile in Illinois. During the years at issue (fiscal years ending 1980-82), Beatrice was a diversified company engaged primarily in providing food and food-related products in California and throughout the world.

Beatrice also produced other consumer, industrial, and chemical products.

Beatrice owned certain foreign subsidiaries with which it was not engaged in a unitary business. These nonunitary foreign subsidiaries paid dividends to Beatrice of \$27 million for 1980, \$29 million for 1981, and \$19 million for 1982.

In the operation of its unitary business, Beatrice took out loans and incurred interest expense in connection with these loans. None of these loans was related to borrowings of Beatrice's nonunitary subsidiaries that made the dividend payments to Beatrice described above. Instead, those subsidiaries were responsible for their own borrowings. The outstanding loans amounted to \$794 million for 1980, \$610 million for 1981, and \$1.3 billion for 1982. The interest expense with respect to these loans amounted to \$80 million for 1980, \$55 million for 1981, and \$137 million for 1982.

2. California's Taxing Scheme

California imposes a franchise tax measured by net income on corporations for the privilege of doing business in California. Cal. Rev. & Tax. Code §§ 23151, 23151.1. For a corporation like Beatrice, which is engaged in business within and without the State, California divides the corporation's income into two categories: business income and nonbusiness income. Business income, which is apportioned by formula among all the

States in which the taxpayer does business,[3] means "income arising from transactions and activity in the regular course of the taxpayer's trade or business. . . ." Cal. Rev. & Tax. Code § 25120(a). Nonbusiness income, which generally is allocated to a particular State depending on its situs, "means all income other than business income." Cal. Rev. & Tax. Code § 25120(d).

These definitions are generally "quite compatible with the unitary business principle." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 786 (1992). Under this principle, a State may tax an apportioned share of a nondomiciliary taxpayer's income arising from its unitary business, but generally may not tax income that is not connected with its unitary business (for example, dividend income received from nonunitary subsidiaries).[4] It is stipulated in this case that "[a]ll of th[e] nonunitary dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California." Joint Stipulation of Facts ("Stip.") ¶ 8, Clerk's Transcript ("CT") p. 58.

[3] The formula determines the taxable "slice" of the apportionable "pie" of business income that is fairly attributable to California. During the years at issue, the apportionment percentage was the simple average of three fractions – the taxpayer's in-state property over its total property, its in-state payroll over its total payroll, and its in-state sales over its total sales. Cal. Rev. & Tax. Code § 25128.

[4] If the nonbusiness income has its situs in the State, *e.g.*, income from real property located in the State but unrelated to the taxpayer's trade or business, then the State may, of course, tax a nondomiciliary taxpayer's income from such property. *See* Cal. Rev. & Tax. Code § 25124.

California law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a). Any interest expense attributable to business income must be subtracted from such income, thereby reducing the income subject to apportionment, and any interest expense attributable to nonbusiness income must be subtracted from such income, thereby reducing the income subject to allocation. CT p. 58.[5] This reflects the widely accepted principle of income tax law and practice generally and in California that expenses should be allocated to the category of income to which they are properly attributable. *See Great Western Fin. Corp. v. Franchise Tax Bd.*, 4 Cal. 3d 1, 6, 479 P.2d 993 (1971) (quoting 12 Marshall, Cal. Practice, State and Local Taxation (1969)). There is no dispute in this case about the propriety of this principle.

The dispute in this case centers on California's statutory deviation from this principle – the so-called "interest offset" provision – which provides three rules that disallow a deduction for interest expense that is otherwise deductible. Cal. Rev. & Tax. Code § 24344(b).[6]

[5] The California tax form upon which the interest offset was computed starts with total interest expense. From this amount, nonbusiness interest expense is subtracted, leaving only business interest expense subject to the interest-expense disallowance rule here at issue. Stip. ¶ 11, CT p. 58.

[6] The statute provides:

> If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus

- First, California disallows a deduction for any net interest expense[7] to the extent that the taxpayer receives nonbusiness interest and dividends – including, as in this case, dividends from nonunitary subsidiaries that California lacks the constitutional power to tax. The statute disallows this expense even when the interest expense is unrelated to the production of the dividend income.

- Second, California permits domiciliary corporations, but not nondomiciliary corporations, to reduce their taxable income by interest expense deductions in the amount of dividends received from nonunitary corporations. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question.

- Third, California provides a limited exception to the rule denying the interest expense deduction

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> the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

Cal. Rev. & Tax. Code § 24344(b).

[7] California permits a taxpayer to offset its business interest expense against its "interest income subject to allocation by formula," Cal. Rev. & Tax. Code § 24344(b), *i.e.*, apportionable or "business" interest income. Hence, it is the "net" business interest expense – the interest expense attributable to business income that remains after subtracting apportionable interest income – that is at issue here.

to nondomiciliaries, but only to the extent that the dividends derive from corporations that are taxable in California.[8]

3. The Assessment

During the audit of Beatrice for the years at issue, the Franchise Tax Board (the "Board") applied the interest offset provision and disallowed Beatrice's net interest expense on a dollar-for-dollar basis by the amount of the constitutionally exempt dividend income Beatrice received from its nonunitary subsidiaries. The basis for the Board's disallowance of Beatrice's interest expense deduction was simply that Beatrice had received nonbusiness dividends. Stip. ¶ 14, CT p. 59. The Board made no determination that the interest expense bore any relationship to the constitutionally exempt dividends, and the statute did not require that it do so. As a consequence, the Board reduced Beatrice's interest expense, and increased its business income subject to apportionment by California, by the amount of the exempt dividend

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[8] Under Cal. Rev. & Tax. Code § 24344(b), a taxpayer must reduce its otherwise deductible interest expense by dividends received from nonunitary corporations "except dividends deductible under the provisions of Section 24402." Dividends deductible under Cal. Rev. & Tax. Code § 24402 are dividends declared from income that has already been subject to tax in California. Accordingly, the exception to the required reduction in deductible interest expense – and the consequent increase in California taxable income – is correlated to the proportion of the taxpayer's dividend-paying subsidiaries' business that is conducted in California.

income: $27 million for 1980, $29 million for 1981, and $19 million for 1982. This resulted in tax deficiencies of $139,066, $170,486, and $109,640, respectively.

4. The Proceedings Below

In March 1996, Petitioner filed suit for a refund of taxes and interest in the Superior Court, City and County of San Francisco. Verified Complaint for Refund of Taxes ("Complaint"), CT p. 1. Petitioner alleged, among other things, that Cal. Rev. & Tax. Code § 24344(b) violated the Commerce and Due Process Clauses of the United States Constitution[9] by arbitrarily limiting its interest expense deduction by the amount of its constitutionally exempt dividend income. Complaint ¶¶ 21-22, CT p. 4.

(a) **The Superior Court**. In June 1997, the Superior Court found that Cal. Rev. & Tax. Code § 24344(b) violated the Commerce and Due Process Clauses. Turning first to the Due Process Clause claim, the court grounded its analysis in two basic, and undisputed, principles: first, "that a state may not tax plaintiff's nonbusiness dividends because plaintiff is a foreign nondomiciliary corporation and such income is only taxable in its state of domicile"; second, "that a state cannot tax indirectly that which it may not tax directly." App. 22a. These principles, the court reasoned, led inexorably to the conclusion that California's disallowance of Beatrice's interest expense

[9] Petitioner additionally argued at trial and on appeal that Cal. Rev. & Tax. Code § 24344 violated the Equal Protection Clause of the Fourteenth Amendment. Although petitioner is not pressing that claim here, the claim is being pursued in Docket No. 98-1967.

deduction violated the Due Process Clause because "[i]t disallows interest deductions on a dollar-for dollar basis with non-taxable dividend income without regard to whether or not such interest is *related* to the dividend income." App. 26a (emphasis in original).

The court recognized that California might constitutionally deny an interest expense deduction that was related to income that California could not tax. App. 26a. But "such potential legitimate state purpose" (App. 26a) simply had no application to this case because

> here the parties have stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any nonunitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends.

App. 26a-27a.

The court likewise found that Cal. Rev. & Tax. Code § 24344(b) violated the Commerce Clause. Because only domiciliary corporations received any tax benefit from the offset of interest expense against nonunitary dividends, the court observed that it will always be true that "the amount of tax on a foreign corporation under Rev. & T.C. §24344(b) will be higher than that of a domestic corporation where both have a) the same taxable business income; b) the same interest expense deductions; and c) the same dividend income." App. 29a. This discrimination against foreign corporations, the court concluded, could not be squared with this Court's precedents barring discrimination against out-of-state corporations.

App. 28a-29a (citing, among other cases, *Fulton; Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997), and *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984)). Moreover, the differential treatment of in-state and out-of-state corporations could not be justified by any purported relationship of the interest expense to the nonunitary dividends, since the record was clear that no such relationship existed. App. 30a.

(b) **The Court of Appeal**. In December 1998, the Court of Appeal reversed the decision of the Superior Court. The Court of Appeal conceded that, "[i]f we were writing on a clean slate," petitioner's arguments "might appear persuasive." App. 8a. Nevertheless, the Court of Appeal believed it was bound by a 1972 decision of the California Supreme Court, *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 498 P.2d 1030 (1972) ("*Pacific Telephone*"), which upheld the Board's interpretation of Cal. Rev. & Tax. Code § 24344(b), even though the Court of Appeal admitted that "the *Pacific Telephone* case did not involve a constitutional challenge to section 24344." App. 8a.

In rejecting petitioner's contention that the disallowance of an interest deduction based on the receipt of tax-exempt dividends effectively taxed such dividends in violation of the Due Process Clause, the Court of Appeal felt constrained by the determination of the California Supreme Court in *Pacific Telephone* that the "inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." App. 8a. Rather than defending this position, the court below simply declared that "[w]e defer, as we must, to that decision," even though *Pacific Telephone* was not based on constitutional considerations. App. 8a.

In dismissing petitioner's Commerce Clause argument, the Court of Appeal again relied principally on "our Supreme Court's holding in *Pacific Telephone* that the interest offset provision does not constitute a tax on the dividends in question." App. 9a. Hence Commerce Clause restraints applicable to taxes were not relevant because "our high court has held the interest offset provision is not a tax on the income in question here." App. 12a. The court found this Court's decision in *Fulton* distinguishable, even though it struck down a statute like California's which conferred a tax benefit based on the extent of a taxpayer's in-state presence, on the ground that here the "alleged favorable effect on local commerce is indirect and incidental." App. 9a. As for the long line of cases from this Court holding facially discriminatory taxes violative of the Commerce Clause, the Court of Appeal found them "not determinative" because "[i]n the absence of a directly applicable ruling by the federal Supreme Court holding unconstitutional an interest offset provision such as the one in issue here, we remain bound by *Pacific Telephone*." App. 10a.[10]

(c) **The California Supreme Court**. On March 24, 1999, the California Supreme Court denied Hunt-Wesson's petition for review. App. 43a.

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[10] The Court of Appeal did not certify its opinion for publication, which means that, with certain exceptions, it may not be cited as binding precedent in California.

REASONS FOR GRANTING THE PETITION

The decision of the California Court of Appeal warrants review by this Court for two compelling reasons. First, the Court of Appeal's determination is irreconcilable with controlling decisions of this Court. These decisions make it clear that a State may not increase a taxpayer's taxable income just because it receives other income that is tax-free. Yet that is precisely the effect of the California interest offset provision. This Court's decisions make it equally clear that a State may not limit a tax benefit to its own domiciliaries or to those who invest in corporations conducting in-state rather than out-of-state activity. Yet that too is the inexorable effect of Cal. Rev. & Tax. Code § 24344(b).

Second, the Court of Appeal's decision, if allowed to stand, would open a gaping hole in the constitutional structure that protects state taxpayers from illegal exactions. If respondent is right, and a State may constitutionally increase a taxpayer's income merely by disallowing a deduction equal to constitutionally exempt income, even when there is no justification for denying the deduction other than the receipt of such exempt income, then the constitutional restraints on state taxation of such exempt income are virtually meaningless. The significance of such a holding extends far beyond the 40,000 corporations who file income tax returns reporting activities within and without California[11] – the world's

[11] Letter from California Attorney General Bill Lockyer to the Court of Appeal, Jan. 4, 1999. App. 39a-42a.

seventh largest economy.[12] It extends to every multistate taxpayer in every State, which will now be empowered to tax the multistate taxpayer's constitutionally exempt income by the simple device of disallowing a deduction equal to such income. The extraordinary implications of such a rule, which undermine essential constitutional restraints on state taxation, require review by this Court.

I. THE DECISION BELOW CONFLICTS WITH SETTLED DECISIONS OF THIS COURT

A. California's Denial of a Deduction for Interest Expense Violates the Well-Settled Rule that a State May Not Tax Constitutionally Exempt Income Under the Guise of Denying a Deduction for Expenses Equal to Such Exempt Income

The practical effect of Cal. Rev. & Tax. Code § 24344(b) is to tax income that is constitutionally exempt from tax. This conclusion follows from three essentially undisputed propositions. First, the dividends that Beatrice received from its nonunitary subsidiaries are not constitutionally taxable by California. *See* Stip. ¶ 8, CT p. 57; *see also ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F. W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). Second, the only reason why respondent disallowed Beatrice's interest expense is because Beatrice received such constitutionally exempt income. *See* Stip. ¶ 12, CT p. 58. Third, as the trial court observed, "it appears that no portion of the interest

[12] California Trade and Commerce Agency, Office of Economic Research, *California: An Economic Profile*, p. 9 (1998).

expense deduction can be attributable to the generation of the . . . exempt dividends." App. 27a. It is therefore plain that the increase in Beatrice's taxable income is attributable to the receipt of exempt income, which the interest expense did not generate, and that the practical effect of Cal. Rev. & Tax. Code § 24344(b) is to tax Beatrice's exempt dividends.

The California Court of Appeal viewed the essential dispute in this case as whether the *legal* effect of Cal. Rev. & Tax. Code § 24344(b) is the same as its *practical* effect. Relying on the California Supreme Court's opinion in *Pacific Telephone*, it concluded that the answer to this question is no. In its view, the legal effect of denying a deduction is different from its practical effect on the ground that "inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." App. 8a. Such elevation of form over substance, however, has no place in constitutional analysis,[13] as it runs counter to a long line of this Court's decisions.

It is, of course, "a just and well-settled doctrine established by this court, that a State cannot do that indirectly which she is forbidden by the constitution to

[13] The Court has made it clear in analyzing constitutional restraints on state taxes that its decisions "consider[ ] not the formal language of the tax statute but rather its practical effect," *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); that they evaluate "state taxation based upon its actual effect rather than its legal terminology," *American Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266, 295 (1987); and that they are grounded in "economic realities." *Id.*

do directly." *Passenger Cases*, 48 U.S. 283, 458 (1848) (plurality opinion). The Court has consistently applied this "great principle" (*id.* at 459) to invalidate state exactions that purport to tax indirectly what the Constitution forbids States from taxing directly. *See, e.g., id.* (striking down an exaction on foreign passengers as a prohibited "duty on tonnage," U.S. Const. art. I, § 10, cl. 3); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) (striking down state estate tax on the ground that "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail"); *Lee v. Osceola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643 (1925) (striking down state tax scheme that would "accomplish indirectly the collection of a tax against the United States which could not be directly imposed").

California's interest offset provision is a paradigmatic example of a State's effort to tax indirectly what it may not tax directly. By reducing an otherwise allowable interest expense deduction on a dollar-for-dollar basis by the amount of dividend income it may not constitutionally tax, California increases a nondomiciliary corporation's tax base by the exact amount of the exempt income. Because the statute does not require – and the facts do not reveal – any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the exempt income.

This Court has condemned, in general, efforts like California's to evade constitutional restrictions on state taxing power by circuitous means. It also has condemned specifically, in a related context, the precise mechanism that California seeks to employ here to tax the exempt

income. In *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928), this Court struck down a provision of the federal income tax law which permitted insurance companies to exclude municipal bond interest from their gross income but at the same time required the insurance companies to reduce an unrelated deduction for reserves by the full amount of the exempt interest. In other words, for each dollar of tax-exempt income the taxpayer received, it had to reduce an otherwise allowable deduction by one dollar. Treating the disallowance of the deduction for what it was – a transparent effort to tax exempt income by denying an unrelated deduction in the same amount – the Court ruled that "[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free." *Id.* at 519.

The statutory provision invalidated in *National Life* is remarkably similar to the California provision at issue here. In each case, a taxpayer is ordinarily entitled to claim a deduction that reduces its income tax base; in each case the taxpayer is required to forgo the deduction, and thereby increase its taxable income, by the amount of its exempt income; and in each case, the deduction need not – and does not – bear any relationship to the exempt income in question. In short, the Court of Appeal's decision sustaining California's interest offset provision cannot be squared with the rationale of *National Life* – that one may not be subjected to greater burdens upon taxable income solely because one receives income that is tax-exempt.[14]

[14] As noted above (*see supra*, p. 9), California's interest offset provision cannot be defended on the ground that it serves to match interest expense with the income it produces. Beatrice made no direct operating loans to its dividend-paying subsidiaries, which were responsible for their own borrowings. Stip. ¶ 9, CT p. 58. Nor is there any evidence in the case linking the interest expense even indirectly to the subsidiaries' income-producing activities. Indeed, rather than disputing the proposition that "the interest offset is overbroad, because it fails to apportion interest expense," App. 8a, the Court of Appeal acknowledged the proposition's "persuasive" force (App. 8a), but felt compelled to follow the earlier ruling of the California Supreme Court in *Pacific Telephone*. *See supra*, pp. 12-13. Moreover, the interest offset provision cannot be justified as a provision designed to match interest expense to exempt nonbusiness income, because any nonbusiness interest expense already is excluded as a deduction before the interest offset is computed. Stip. ¶ 11, CT p. 58. Accordingly, the interest offset operates only to match deductible interest expense with nontaxable income – a practice that is incompatible with controlling doctrine and case law.

B. California's Provision of More Favorable Interest Expense Deductions for Domiciliary Than for Nondomiciliary Corporations Flies in the Face of This Court's Controlling Commerce Clause Decisions

The rule prohibiting taxes that discriminate against interstate commerce is a central tenet of this Court's Commerce Clause doctrine. *See, e.g., Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93 (1994). No aspect of this doctrine is more firmly established than the principle that a State may not favor in-state over out-of-state entities. Indeed, just a few months ago, the Court applied this principle in striking down Alabama's franchise tax in *South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999). Alabama's taxing scheme favored domestic over foreign corporations by giving domestic – but not

foreign – corporations the ability to reduce their franchise tax liability by reducing the par value of their stock. *Id.* at 1185-86. Observing that the tax "facially discriminates against interstate commerce," *id.*, a unanimous Court invalidated the tax in short order.

California's preference for its own domiciliary corporations is no different in substance from Alabama's domestic preference legislation condemned in *South Central Bell*. As in *South Central Bell*, there can be no dispute that the taxing scheme in question treats local corporations more favorably than their out-of-state competitors: only domiciliary corporations receive the full benefit of an interest expense deduction against taxable income when they receive dividends from nonunitary corporations. Nondomiciliary corporations, by contrast, must forgo the benefit of the interest expense deduction to the extent of their nonunitary dividends. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question. Since the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the "virtually per se rule of invalidity" that this Court applies to facially discriminatory taxes. *See, e.g., Camps/Newfound Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 596 (1997).

Contrary to the suggestion of the court below, it is of no constitutional moment that California's disparate treatment of nondomiciliary corporations takes the form of the discriminatory denial of a deduction rather than the discriminatory imposition of a tax. *See* App. 9a ("the interest offset provision does not constitute a tax on the dividends in question"). The Commerce Clause bars discrimination against interstate commerce "whether forthright or ingenious." *Best & Co. v. Maxwell*, 311 U.S. 454, 455 (1940). This Court's opinions attest to the fact that the form of the tax preference – be it the discriminatory imposition of a tax or the discriminatory denial of an exemption, deduction, or credit – is constitutionally irrelevant.[15]

C. California's Allowance of Interest Expense Deductions Based on the Extent to Which a Corporation's Subsidiaries Conduct Business in California Is Indistinguishable from the State Taxing Scheme Condemned in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996)

California not only discriminates in favor of domiciliary over nondomiciliary corporations, but also discriminates against interstate commerce in another (and equally offensive) way. California does not deny an interest

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[15] *See Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 404-05 (1984) ("Nor is it relevant that New York discriminates against business carried on outside the State by disallowing a tax credit rather than by imposing a higher tax. The discriminatory economic effect of these two measures would be identical. . . . We have declined to attach any constitutional significance to such formal distinctions that lack economic substance."); *Maryland v. Louisiana*, 451 U.S. 725, 756 (1981) ("the Louisiana First-Use Tax unquestionably discriminates against interstate commerce . . . as the necessary result of various tax credits and exclusions"); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 211 (1994) (Scalia, J., concurring) (an " 'exemption' from or 'credit' against a 'neutral' tax, is no different in principle from [a discriminatory tax], and has likewise been held invalid").

expense deduction to a nondomiciliary corporation insofar as it receives dividends from nonunitary corporations that engage in taxable activity in California. But this limited exception to the unconstitutional rule denying an interest expense deduction itself discriminates on its face against interstate commerce by conditioning a tax benefit (the deductibility of interest expense) on the extent of a corporation's in-state activity. In this respect, California's interest offset provision is virtually identical to the North Carolina taxing scheme this Court struck down in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

In *Fulton*, the Court considered a North Carolina intangible property tax as applied to taxpayers who owned corporate stock. The tax was imposed at the rate of 0.25 percent of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. Under this regime, if the stock was issued by a corporation doing all of its business in North Carolina, a 100 percent reduction of the value of the stock would be allowed; if the stock was issued by a corporation doing 50 percent of its business in North Carolina, a 50 percent reduction of the value of the stock would be allowed; and if the stock was issued by a corporation doing none of its business in North Carolina, no reduction of the value of the stock would be allowed.

The Court had no hesitation in branding North Carolina's taxing scheme as "facially" discriminatory (*id.* at 333):

> A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Id.

California's interest offset scheme suffers from precisely the same constitutional infirmity. It permits an interest deduction against taxable income (and thus a reduction in California tax) only to the extent that a nonunitary, dividend-paying subsidiary does business in California. Thus, just as in North Carolina, the taxpayer receives a tax benefit only insofar as the corporation in which it has invested is doing business in the State. If the taxpayer's nonunitary, dividend-paying subsidiary were doing all of its business in California, a 100 percent deduction of the taxpayer's otherwise deductible interest expense would be allowed; if the taxpayer's nonunitary, dividend-paying subsidiary were doing 50 percent of its business in California, 50 percent of the taxpayer's otherwise deductible interest expense would be allowed; and if the taxpayer's nonunitary, dividend-paying subsidiary were doing none of its business in California, none of the taxpayer's otherwise deductible interest expense would be allowed.

The Court's conclusion with regard to the North Carolina regime applies equally to the California regime:

> A regime that [denies an interest deduction] only to the degree that [the dividend-paying subsidiary] participates in interstate commerce

> favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Fulton, 516 U.S. at 333. Accordingly, Cal. Rev. & Tax. Code § 24344(b) "facially discriminates against interstate commerce." *Id.*

II. IF ALLOWED TO STAND, THE DECISION BELOW WILL SERIOUSLY UNDERMINE CONSTITUTIONAL RESTRAINTS ON STATE TAXATION

The decision below poses a serious threat to constitutional restraints on state taxation by allowing a State to evade those restraints through the simple expedient of disallowing a deduction for expenses equal – but unrelated – to constitutionally exempt income. If left undisturbed, it will provide a roadmap for circumvention of the most basic of constitutional limitations embedded in this Court's doctrine – namely, the bar against taxing income with which the State has no connection. If a State can increase its income subject to tax by the transparent device of denying an expense equal – but unrelated – to income which is constitutionally exempt from tax, then the bar on taxing such exempt income is illusory. Yet that is precisely what California has done here.

The impact of the Court of Appeal's decision is not merely theoretical. The California Attorney General, in a

letter urging the Court of Appeal to publish the decision below,[16] declared:

> The question answered in the *Hunt-Wesson* case is whether Revenue and Taxation Code Section 24344(b) is constitutional. The constitutionality of a section of the Revenue and Taxation Code is of great significance to the taxpayers and the state. Over 40,000 corporations file returns which report their activities both within and without California. These corporations pay over 70% of the bank and corporation tax collected by California. Each of these corporations has the potential to have income which is apportioned by formula and income which is not apportioned by formula so that the amount of interest expense and the manner in which it will be taken into account is governed by Section 24344(b).

Letter from California Attorney General Bill Lockyer to the Court of Appeal, Jan. 4, 1999. App. 39a-42a.

California is the world's seventh largest economy[17] – with corporate franchise tax revenues alone of more than $5.8 billion.[18] Even if the impact of the decision below were limited to California, it would warrant this Court's review because of the enormous effect it will have on

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[16] As noted above, *see supra* note 10, the Court of Appeal did not certify the decision below to be published.

[17] California Trade and Commerce Agency, Office of Economic Research, *California: An Economic Profile*, p. 9 (1998).

[18] California State Comptroller's Office, State of California Comprehensive Annual Financial Report for the Year Ended June 30, 1998.

multistate taxpayers, the overwhelming majority of which do business in California.

But the impact of the Court of Appeal's decision is not so limited. If the decision below is left undisturbed, it will pave the way for every State to avoid the constitutional limitations on its taxing powers. The decision below, after all, stands for a proposition of astonishing breadth: A State may constitutionally increase a taxpayer's income merely by disallowing an expense deduction equal to constitutionally exempt income, even when there is no evidence of any relationship between the disallowed expense and the exempt income. Moreover, the States are well aware of the *Hunt-Wesson* case, since it has been the topic of frequent discussion in the state tax literature[19] and at state tax conferences.[20]

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[19] *See, e.g.*, Wethekam & Egr, *State and Local Tax Update*, State Tax Today (Sept. 3, 1998); Rosen & Smith, *1997 National State and Local Tax Developments*, State Tax Today (Mar. 17, 1998); Wright, *California's Interest Offset Runs into a Constitutional Glitch*, State Tax Today (Nov. 13, 1997); Herbert, Stanislawski & Kessler, *Defending the Castle Walls: California's Interest Offset, Dividends Received Deduction Should Crumble Soon*, State Tax Today (Oct. 29, 1997); Multistate Tax Analyst, *Discriminatory Taxation – California: Interest Offset Requirement Survives Constitutional Challenge*, Vol. 11, No. 8, p. 6 (Mar. 31, 1999); *cf.* J. Hellerstein & W. Hellerstein, State Taxation, Vol. 1, ¶¶ 4.13[2][k][v], 9.10[1][e][ii] (3d ed. 1998) (discussing the Superior Court's decision).

[20] *See, e.g.*, Willson, *Current Developments in State and Local Taxation: A Nationwide Perspective*, Georgetown University Law Center Continuing Legal Education State and Local Tax Institute (May 20, 1999); Uzes, McIntyre & Leung, *The Allocation of Expenses – Testing the Limits of California's Taxing Scheme*, 1998 California Tax Policy Conference: Issues in State Taxation (Nov. 11-13, 1998); Miller, Green, & Nielsen, *Litigation – Past, Present and Future*, 1997 California Tax Policy Conference: Issues in State Taxation (Nov. 5-7, 1997).

In short, the decision below has implications not only for California, but for every State and for every taxpayer that conducts business across state lines. Unless quickly repudiated, the decision will allow California effectively to continue to tax income that is beyond its constitutional reach and is likely to embolden other States to follow California's lead. In these circumstances, this Court should grant review of the decision below.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

Respectfully submitted,

Drew S. Days III
127 Wall Street
New Haven, CT 06520
(203) 432-4948

Walter Hellerstein
University of Georgia
Law School
Herty Drive
Athens, GA 30602
(706) 542-5175

Charles J. Moll III
(*Counsel of Record*)
Edwin P. Antolin
Morrison & Foerster LLP
425 Market Street
San Francisco, CA 94105
(415) 268-6497

Fred O. Marcus
Horwood, Marcus &
Berk, Chartered
333 West Wacker Drive,
Suite 2800
Chicago, IL 60606
(312) 606-3210

Counsel for Petitioner

APPENDIX A

NOT TO BE PUBLISHED IN OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE
STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION THREE

HUNT-WESSON, INC., Plaintiff and Respondent, v. FRANCHISE TAX BOARD, Defendant and Appellant.	(Filed Dec. 11, 1998) A079969 (San Francisco County Super. Ct. No. 976628)

The Franchise Tax Board (the Board) appeals from a judgment ordering the refund of over $2 million in franchise taxes and interest to respondent Hunt-Wesson, Inc. (Hunt-Wesson). The Board contends the trial court erred in holding unconstitutional Revenue and Taxation Code section 24344.[1] We agree, based on our Supreme Court's decision in *Pacific Tel. & Tel. Co.* v. *Franchise Tax Bd.* (1972) 7 Cal.3d 544 (*Pacific Telephone*), and therefore reverse the judgment.

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[1] Subsequent statutory references are to the Revenue and Taxation Code.

Factual and Procedural Background

Respondent Hunt-Wesson is a Delaware corporation, domiciled in Illinois, and engaged in business in California and elsewhere.[2] During the relevant years, respondent owned, and received dividends from, certain nonunitary subsidiaries, none of which were incorporated in California and most of which were incorporated under the laws of a foreign country. The dividends constituted nonunitary, nonbusiness income and were not subject to apportionment, or taxation, by California.[3] Respondent made no direct operating loans to the subsidiaries during the relevant years.

Respondent claimed deductions for certain business interest expenses on its California franchise tax returns. Following an audit, the Board disallowed the deductions, dollar for dollar, to the extent the dividends were received from nonunitary subsidiaries, pursuant to the interest offset provision of section 24344. Respondent paid the proposed deficiencies[4] and filed a timely claim for refund. The case was submitted on stipulated facts, and the trial court ruled that section 24344 violates the Due Process, Equal Protection, and Commerce Clauses of

[2] The facts are summarized from the parties' Joint Stipulation of Facts. Hunt-Wesson is a successor in interest to Beatrice Companies, Inc. and Beatrice Foods Company, also Delaware corporations domiciled in Illinois.

[3] The dividends were taxable by Illinois, respondent's state of domicile.

[4] Respondent also agreed to permit the Board to credit an overpayment against the proposed deficiencies.

the United States Constitution. This appeal followed an order of refund below.

Issue on Appeal

Whether the interest offset provision of section 24344 is unconstitutional is a question of law over which this court exercises independent review. (*GTE Sprint Communications Corp.* v. *State Bd. of Equalization* (1991) 1 Cal.App.4th 827, 832.) "The power of the Legislature in the area of taxation is paramount, and any constitutional restriction on that power must be strictly construed against the limitation. [Citation.]" (*Franchise Tax Bd.* v. *Superior Court* (1989) 212 Cal.App.3d 1343, 1347.) Every statute is presumed constitutional (*County of Sonoma* v. *State Energy Resources Conservation etc. Com.* (1985) 40 Cal.3d 361, 368), and must be upheld unless it is " 'clearly, positively, and unmistakably' " unconstitutional. (*Calfarm Ins. Co.* v. *Deukmejian* (1989) 48 Cal.3d 805, 814.) Any doubt must be resolved in favor of the legislation; even if its validity is "fairly debatable," it must nonetheless be sustained. (*Id.* at pp. 814-815.)

When a corporation derives income from sources both within and outside the state, California's corporate franchise tax is measured by net income attributable to in-state sources. (§§ 23151, 25101.) California follows the Uniform Division of Income for Tax Purposes Act (UDITPA) (§ 25120 et seq.), which makes a distinction between business and nonbusiness income.[5] Business

[5] Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's

income is generally calculated by applying an apportionment formula based on sales, property and payroll to the corporation's unitary business income. (§ 25128.) Nonbusiness dividend income is not apportioned, but is taxable by the corporation's state of domicile. (§§ 25123, 25126.)

In calculating taxable net income under the apportionment approach, section 24344 provides for the deduction of interest expense, subject to certain limitations.[6] Pursuant to subsection (b), interest expense is fully deductible to the extent of business interest income. Additional interest expense is then offset against nonbusiness interest and dividend income (which is not subject to allocation by formula), with the remaining interest

trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (§ 25120, subd. (a).) Nonbusiness income is "all income other than business income." (§ 25120, subd. (d).)

[6] For the relevant years, former section 24344 provided: "(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer. [¶] (b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and divided income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula."

deductible. Applying this section, the Board disallowed Hunt-Wesson's interest expense deduction on a dollar-for-dollar basis to the extent it received dividends from its nonunitary subsidiaries. Hunt-Wesson claims the application of the interest offset provision violates the Due Process and Commerce Clauses because it indirectly taxes nonbusiness dividends which could not be taxed directly, and discriminates against corporations domiciled outside California. Hunt-Wesson also argues the statute violates the Equal Protection Clause by creating an irrational classification that discriminates solely on the basis of a corporation's state of domicile.

Division One of this court recently noted that "[t]he theory of this interest offset rule is that a corporation should not be able to borrow money to purchase stocks that pay dividends and then get a deduction for the interest while the dividend income (being investment or nonbusiness income) is not taxable. [Citation]." (*Willamette Industries, Inc.* v. *Franchise Tax Bd.* (1995) 33 Cal.App.4th 1242, 1246-1247 (*Willamette*).) The *Willamette* court relied on our Supreme Court's ruling in *Pacific Telephone, supra,* 7 Cal.3d at page 554, which continues to bind us here.[7]

In *Pacific Telephone, supra,* the Supreme Court held that the Legislature had acted reasonably by treating interest expense as the opposite of dividend income, and by requiring the offset of the one against the other. (7

[7] The *Willamette* court ultimately concluded the interest offset rule did not apply in that case, because the dividends were business income, which is apportioned. (*Supra,* 33 Cal.App.4th. at pp. 1246, 1250.) That issue is not present here.

Cal.3d at pp. 551-552.) The high court rejected the taxpayer's argument that the offset should apply only to taxable dividend income. (*Id.* at pp. 553-556.) The court noted that the dividend income of a foreign corporation is not taxable in California, but concluded it comes within the language and logic of the offset statute, which is designed to offset interest expense against investment income.[8] (*Id.* at pp. 552-554.) The court noted that otherwise a tax loophole would be created, and that "a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money." (*Id.* at p. 556.)

The Supreme Court held that inclusion of nontaxable dividends in the statutory offset computation did not constitute taxation of the dividends themselves, which were reasonably used to offset the interest expense deduction. (*Pacific Telephone, supra,* 7 Cal.3d at p. 555.) The court noted that "California has a substantial interest in making sure that income attributable to this state is not distorted by use of the interest expense deduction, and under subsection (b), the dividends received are only taken into account to offset the interest expense deduction." (*Id.* at p. 556; see also *Lyon Metal Products, Inc.* v. *State Bd. of Equalization* (1997) 58 Cal.App.4th 906, 913-914 (*Lyon*) [Legislature validly closed sales tax loophole by

[8] At the time of the *Pacific Telephone* decision, dividends of a foreign corporation were not taxable based on the doctrine of *mobilia sequuntur personam* ([movables follow the person]). (*Supra,* 7 Cal.3d. at p. 552.) Under current tax law, that doctrine has been replaced by the business/nonbusiness distinction discussed above.

adding drop shipment rule to reach transactions through out-of-state intermediaries, per Division Five of this District]; *Armour & Co.* v. *Wisconsin Department of Taxation* (1948) 32 N.W.2d 324, 326 [upholding similar restriction on interest deduction as constitutional].)[9]

Hunt-Wesson contends that the interest offset provision of section 24344 impermissibly taxes dividends which are constitutionally immune from taxation by California, and therefore violates the federal Due Process Clause. The Due Process Clause limits a state's power to impose a tax on an activity which is not connected with the taxing state. (*Allied-Signal, Inc.* v. *Director, Div. of Taxation* (1992) 504 U.S. 768, 777-778.) Thus a state may not constitutionally tax income dividends which a nondomiciliary corporation receives from subsidiary corporations having no other connection with the state. (*ASARCO, Inc.* v. *Idaho State Tax Comm'n* (1982) 458 U.S. 307, 327-329.)

Hunt-Wesson argues that the interest offset provision of section 24344 constitutes an indirect tax on immune

[9] In explaining its reasons for declining to limit the coverage of subdivision (b) to taxable dividends in *Pacific Telephone, supra,* the Supreme Court listed as an additional factor the language of the section itself, which is phrased as a limitation on the deduction of interest expense. The court noted this view was reinforced by a letter sent from the Board to Governor Knight, before he signed the legislation, stating the provision would increase taxes on foreign corporations while reducing those of domestic corporations. (7 Cal.3d at p. 554.) Despite that potential indirect effect on foreign corporations, the Supreme Court upheld the interest offset provision, determining that it did not constitute a tax. (*Id.* at p. 555.)

income, increasing a nondomiciliary corporation's tax liability solely because it receives nontaxable dividends. Hunt-Wesson also argues that the interest offset is overbroad, because it fails to apportion interest expense, but creates a dollar-for dollar offset. If we were writing on a clean slate, these arguments might appear persuasive. In *Pacific Telephone, supra,* however, the California Supreme Court explicitly held that inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves. (7 Cal.3d 544.) We defer, as we must, to that decision. (*Auto Equity Sales, Inc.* v. *Superior Court* (1962) 57 Cal.2d 450, 455.)

Although, as Hunt-Wesson points out, the *Pacific Telephone* case did not involve a constitutional challenge to section 24344, our Supreme Court clearly recognized the dividend income itself was not taxable in California, while upholding the interest offset provision of section 24344. (*Supra,* 7 Cal.3d at pp. 549, 552.) Hunt-Wesson's argument that *Pacific Telephone* is "an outdated, obsolete case" must be addressed to courts of superior jurisdiction to our own.[10]

[10] Hunt-Wesson also argues the language in *Pacific Telephone* is dictum, because the taxpayer, being domiciled in California, did not contest the inclusion of the nonbusiness dividends in the interest offset provision. The taxpayer in *Pacific Telephone,* however, was a member of a unitary business (most of whose members were domiciled outside California) whose California tax liability was greater than it would have been without the application of section 24344 (*supra,* 7 Cal.3d at p. 546), because interest expense, which would otherwise have been an apportionable business expense of the entire unitary business, was assigned to non-California domiciliaries. After the tax year there in issue, the Legislature eliminated unitary intercompany dividends from the tax base and the subsection (b) computation. (*Id.* at p. 558, fn. 11.) The Legislature did not, however, similarly adjust the treatment of non-unitary dividends, which are at issue here. We are unable to distinguish *Pacific Telephone* on any principled basis. Because we conclude the fact asserted by Hunt-Wesson does not serve to distinguish the case, *Pacific Telephone's* holding dictates the outcome here.

Hunt-Wesson also contends the interest offset statute is unconstitutional because it discriminates against interstate commerce in violation of the Commerce Clause. First, Hunt-Wesson argues section 24344 denies the interest deduction only to non-California corporations, imposing a facially discriminatory tax which is "virtually per se invalid." This argument again collides with our Supreme Court's holding in *Pacific Telephone* that the interest offset provision does not constitute a tax on the dividends in question. Moreover, the cases on which Hunt-Wesson relies are distinguishable. In *Fulton Corp.* v. *Faulkner* (1996) 516 U.S. 325, for example, the intangibles tax involved was discriminatory on its face, taxing stockholders only to the degree that the issuing corporation participated in interstate commerce, and the only real issue was whether the deduction in question could be sustained as compensatory. (*Id.* at pp. 333-334.) Here, by contrast, the alleged favorable effect on local commerce is indirect and incidental. Section 24344, which is part of an overall apportioned tax scheme, does not distinguish between domestic and foreign corporations, and the same rules and logic of offsetting interest expense against investment income are applied to both. (See *Pacific Telephone, supra,* 7 Cal.3d at p. 558.) Deductibility of interest

expense is determined not by the corporation's domicile, but by the character of the income attributable to that expense.[11]

Thus the facial discrimination cases (with their concomitant rule of virtual per se invalidity) upon which respondent relies are not determinative. (See, e.g., *Camps Newfound/Owatonna, Inc.* v. *Town of Harrison* (1997) 520 U.S. 564, 572-583 [reduction of state property tax exemption for charities operated principally for benefit of nonresidents was facially discriminatory and thus invalid]; *Oregon Waste Systems, Inc.* v. *Department of Environmental Quality of Ore.* (1994) 511 U.S. 93, 99-100 [surcharge on disposal of waste generated out of state was discriminatory on its face, triggering rule of virtual per se invalidity]; *Philadelphia* v. *New Jersey* (1978) 437 U.S. 617, 623-629 [New Jersey law banning waste imported from other states violated Commerce Clause].) In the absence of a directly applicable ruling by the federal Supreme Court holding unconstitutional an interest offset provision such as the one in issue here, we remain bound by *Pacific Telephone, supra.* In fact, respondent has not cited, and our research has not uncovered, any decision, federal or state, holding such a provision unconstitutional.

[11] The Board points out that domicile is not necessarily the operative component in determining where nonbusiness income is taxable. (See § 25125, subd. (d) [allocation of gain or loss on sale of partnership interest allocable by ratio based on original cost of partnership tangible property both in and out of state]; § 25127 [patent and copyright royalties allocable to extent utilized in state].)

Hunt-Wesson also argues section 24344 unlawfully discriminates by excluding from the interest offset computation under section 24402 dividends declared from income previously taxed by California. Hunt-Wesson contends this exclusion favors investment in California subsidiaries over investment in subsidiaries not doing business in California. Because California has previously taxed the income in question, however, we discern no unconstitutional discrimination in the state refraining from double taxation. (See *Pacific Telephone, supra,* 7 Cal.3d at p. 548, fn. 4.) Unlike *Fulton, supra,* on which respondent relies, the statute does not waive an otherwise uniform intangibles tax, based simply on the percentage of the underlying corporate income taxed by the state. Instead, it operates as part of an overall apportioned tax scheme, matching expenses with income in a manner which our Supreme Court has determined to be reasonable. (*Pacific Telephone, supra,* 7 Cal.3d at pp. 551-552, 555.)

The parties also disagree as to the application of the "internal consistency" test here. (See *Oklahoma Tax Comm'n* v. *Jefferson Lines, Inc.* (1995) 514 U.S. 175, 185.) "Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear." (*Ibid.*) The Board contends that section 24344 does not affect respondent's overall tax liability, because if all the states in which it is taxable adopted similar provisions, respondent's taxable income in Illinois would decrease in proportion to the amount its taxable income in California would increase.

Respondent disagrees, also asserting that internal consistency is not sufficient. We need not decide this theoretical point, because the "internal consistency" standard is applicable only to taxes, and our high court has held the interest offset provision is not a tax on the income in question here. (*Pacific Telephone, supra,* 7 Cal.3d at p. 555.) Moreover, the United States Supreme Court has held that the Commerce Clause does not require absolute precision in interstate taxation, noting that the States have adopted differing rules regarding business and nonbusiness income and their attribution for apportionment purposes. (*Moorman Mfg. Co.* v. *Bair* (1978) 437 U.S. 267, 278-281 [rejecting argument that Commerce Clause prohibits any overlap in computation of taxable income by the States].)

Nor does the interest offset provision deprive appellants of their equal protection rights. Hunt-Wesson concedes that the only inquiry under the Equal Protection Clause is whether there is a rational relationship between the State's classification and its objective. The provision here is rationally related to California's need to close an otherwise gaping tax loophole, as explained in *Pacific Telephone, supra.* Unlike the discriminatory taxes struck down in the cases cited by Hunt-Wesson, section 24344 does not create an arbitrary classification based solely on state of domicile. (Compare *Williams* v. *Vermont* (1985) 472 U.S. 14, 23 [discriminatory exemption from use tax based solely on state of residence did not serve legitimate state purpose]; *Metropolitan Life Ins. Co.* v. *Ward* (1985) 470 U.S. 869, 878 [state may not promote domestic business by

taxing foreign corporations at a higher rate solely because of their residence].)[12]

Disposition

The judgment below is reversed. The matter is remanded to the trial court with directions to enter judgment for the Board.

Corrigan, J.

We concur:

Phelan, P.J.

Walker, J.

A079969, *Hunt-Wesson, Inc.* v. *Franchise Tax Board*

[12] Respondent asserts that the legislative history of section 24344 indicates it was enacted to benefit California corporations, apparently referring to the letter from the Board to Governor Knight mentioned in *Pacific Telephone, supra,* 7 Cal.3d at p. 554. While the letter reportedly stated the provision would increase taxes on foreign corporations while reducing those on domestic corporations, the Board points out here that the letter indicates no intent to discriminate against foreign corporations but merely notes the likely consequence of section 24344 which results from plugging the tax loophole. This is a permissible subject of legislation. (See *Lyon, supra,* 58 Cal.App.4th at pp. 913-914.)

APPENDIX B

SUPERIOR COURT OF CALIFORNIA

CITY AND COUNTY OF SAN FRANCISCO

DEPARTMENT 17

HUNT-WESSON, INC., Formerly Known as Beatrice/Hunt Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods Company, Plaintiff, v. FRANCHISE TAX BOARD, an Agency of the State of California, Defendant.	No. 976628 **PROPOSED STATEMENT OF DECISION [C.C.P. § 632]** (Filed JUN-6 1997)

Upon the oral request of both parties in accordance with Code of Civil Procedure § 632, the Court makes the following Proposed Statement of Decision:

SUMMARY

This case is brought by plaintiff Hunt-Wesson, Inc. to obtain a refund of $2,258,020.44 in taxes and interest paid to the defendant Franchise Tax Board in its fiscal years 1980, 1981 and 1982. This amount is an alleged overpayment plus (accrued interest) resulting from the application of Revenue and Taxation Code ("Rev. & T.C.") § 24344(b) to plaintiff's claimed business interest expense deductions for the subject three tax years. Under Rev. & T.C. § 24344(b), the defendant disallowed a portion of plaintiff's business interest expense on a dollar-for dollar basis with plaintiff's non-unitary subsidiary dividends for the subject years. Plaintiff concedes that Rev. & T.C. § 24344 was applied in accordance with its terms, but asserts that the statutory provisions that allow for business interest expense deductions to be offset by non-unitary dividends violate the Due Process, Commerce and Equal Protection Clauses of the United States Constitution.

FACTS

This matter was submitted upon a Joint Stipulation of Facts filed herein on February 6, 1997 ("JS"), a Supplement to Joint Statement of Facts filed herein on April 11, 1997, and a Second Supplement to Joint Statement of Facts filed herein on May 2, 1997 ("JS 2nd") which establish that:

A. Plaintiff[1] is a Delaware corporation, domiciled in Illinois (JS ¶ 1).

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[1] Plaintiff Hunt-Wesson, Inc. is successor in interest to other entities, the identities of which changed over the years relevant to this action. The details of this evolution, which are specified in the Joint Statement of Facts, are not relevant to this Statement of Decision as Plaintiff is the successor in interest to the actual taxpayer of the disputed payments. For simplicity, the term "Plaintiff" shall be used throughout this Statement to refer to the taxpayer and its successor in interest.

B. During its fiscal years ending February 28 of 1980, 1981 and 1982 ("the relevant fiscal years"), plaintiff was a diversified company engaged in the food products business both within and outside of California (JS ¶ 2).

C. During the relevant fiscal years, plaintiff owned dividend paying subsidiaries, none of which were either incorporated in California or engaged in a unitary business with Plaintiff (JS ¶ 7).

D. The non-unitary subsidiaries paid plaintiff the following dividends: $26,718,620 for fiscal year 1980; $29,482,367 for fiscal year 1981; and $19,022,617 for fiscal year 1982 ("the nonbusiness dividends") (JS ¶ 7).

E. All of the nonbusiness dividends were not taxable by the State of California but were taxable by the State of Illinois (JS ¶ 8).

F. During the relevant fiscal years, plaintiff incurred the following business interest expense, which it claimed as a deduction on its California Franchise Tax Returns for the respective years: $80,490,469 for fiscal year 1980; $55,101,503 for fiscal year 1981; and $137,413,162 for fiscal year 1982 (JS ¶ 10)

G. Exhibit 1 to the Joint Stipulation of Facts is a list of the debt and related expenses giving rise to the foregoing claimed business interest expense deductions. No portion of these amounts was related to borrowings of the non-unitary subsidiaries which provided the above-specified dividends to plaintiff (JS ¶ 9).

H. Pursuant to Rev. & T.C § 24344(b), defendant disallowed plaintiff's business interest expense

deductions on a dollar-for-dollar basis to the extent of the dividends that plaintiff received from its non-unitary subsidiaries (JS ¶12).

I. As a result of the disallowance of business interest expense, plaintiff paid further taxes and interest thereon, the amounts of which plus accrued interest from the respective dates of payment for the relevant fiscal years are as follows: $762,073.12 (consisting of $139,066.00 tax plus $623,007.12 interest accrued from May 15, 1980 through May 1, 1997) for fiscal year 1980; $855,926.32 (consisting of$170,486 tax plus $232,752.71 interest paid plus $452,687.61 interest accrued from March 15, 1989 through May 1, 1997) for fiscal year 1981; and $640,021.00 (consisting of $109, 640.00 tax plus $135,803.62 interest paid plus $394,577.38 interest accrued from July 15, 1989 through May 1, 1997) for fiscal year 1982 (JS 2nd, ¶20).

J. Plaintiff has satisfied all procedural requirements to bring this action for refund of the disputed payments (JS ¶¶21.23, 26).

ISSUES PRESENTED

Plaintiff's claim for refund is based on the argument that the provisions of Rev. & T. C. § 24344(b) which allow this state to offset business interest deductions claimed by foreign corporations on a dollar-for-dollar basis with such corporations' non-unitary dividends violate the Due Process, Commerce and/or Equal Protection Clauses of

the United States Constitution. As a threshold issue, however, it must be determined whether Pacific Telephone & Telegraph v. Franchise Tax Board, 7 Cal. 3d 544 (1972) precludes any Constitutional analysis of the subject provisions.

ANALYSIS

A. The Revenue & Taxation Code

California's Bank and Corporation Tax Law (Rev. & T.C. §§ 23001 et seq) is, in relevant part, a tax on corporations doing business in this state for the privilege of exercising corporate franchises in California. Rev. & T.C. § 23151. When a corporation does business both within and outside of California, the statutory scheme apportions "business income"[2] by the application of a formula which, simply put, determines the portion of such income attributable to three business factors (sales, property and payroll) which are connected with this state and taxes accordingly. Rev. & T.C. 25128. In contrast, corporate dividends are "non-business income" and are not allocated to this state unless the taxpayer is domiciled here. Rev. & T.C. § 25126. Income allocated to California under these rules is taxable by California. Rev. & T.C. § 25101.

In calculating a taxpayer's net taxable income, business interest expense is generally deducted from business income. Rev. & T.C. § 24344(a). Taxpayers must, however, offset their interest expense deductions on a dollar-for-

[2] "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business. Rev. & T.C. § 25120.

dollar basis with any non-business income not allocable to California. Rev. & T.C. §24344(b). This means that corporations not domiciled in California must reduce their interest deduction (in California) by the amount of their nontaxable (by California) dividend income. It is this effect that plaintiff asserts is unconstitutional.

B. Pacific Telephone & Telegraph v. Franchise Tax Board

Defendant asserts that Pacific Telephone & Telegraph v. Franchise Tax Board, supra, 7 Cal. 3d 544, is determinative of the issues in this case.

In Pacific Telephone, the issue presented was whether the phrase "interest and dividend income...not subject to allocation by formula" as an offset against interest deductions under Rev. & T.C. § 24344(b) should be interpreted to include all intercompany dividends.

The Court held that as a matter of statutory interpretation, logic and public policy, such intercompany dividends should be included in the subject phrase. The Court rejected Pacific Telephone's assertion that only *taxable* intercompany dividends be included in the offset because such phrase was not used in the statute and because other non-taxable dividends were expressly excluded from the computation under the statute, which express exclusion would be unnecessary if all nontaxable dividends were to be excluded. 7 Cal. 3d. at 554. The Court also found that logically, dividends are income whether or not taxed. Id. Finally, the Court found that its interpretation that nontaxable dividends should be offset against interest deductions was appropriate to close a potential loophole whereby a foreign corporation could

increase its borrowings to create a deduction and use the loan proceeds to buy stocks which would create nontaxable dividend income. 7 Cal. 3d at 554.

The Court did not expressly discuss any constitutional parameters for its statutory interpretation.[3] The absence of any constitutionally-based holding in Pacific Telephone renders that opinion not controlling on the constitutional challenges raised here. Amwest Surety Ins. Co. v. Wilson, 11 Cal 4th 1243, 1268 (1995) ["an opinion is not authority for a proposition not therein considered," *quoting* Ginns v. Savage, 61 Cal. 2d 520, 524 (1964)].

C. Constitutional Analysis.

Plaintiff asserts that the offset provisions of Rev. & T.C. § 24344 (b) violate three separate clauses of the United States Constitution: the Due Process Clause, the Commerce Clause, and the Equal Protection Clause. As a general matter, every statute is clothed with a presumption of Constitutionality. County of Sonoma v. State Energy Resources Conservation Etc. Comm., 40 Cal. 3d 361, 368-70 (1985). The power of the legislature in the area of taxation is paramount, and any constitutional restriction on that power must be strictly construed against the limitation and with reference to the underlying purpose

[3] It should be noted that the Court stated that the problem confronting it was largely, if not entirely, eliminated by the 1967 enactment of Rev. & T.C. §25106, which expressly dealt with the applicability of intercompany dividends under Rev. & T.C. §24344. This statutory clarification may have reduced the scope of the issues presented to the Court and might therefore explain the absence of any constitutional analysis.

of the legislation. Franchise Tax Board v. Superior Court, 212 Cal.App. 3d 1343, 1347 (1989). With these principles in mind, each of the plaintiff's challenges will be discussed separately.

1. The Due Process Clause

The Due Process Clause of the Fourteenth Amendment to the United States Constitution provides that no state shall deprive its citizens of property without due process of law. In the area of state taxation, due process protections are founded on the principle that the power to tax is exercised upon the assumption that the government is providing an equivalent value to the taxpayer in the form of protections, services or facilities. Union Refrigerator Transit Company v. Kentucky 199 U.S. 194, 202 (1905). If the taxing state government is in no position to render these protections, services or facilities to the taxpayer because the object of taxation is wholly in another state, then an attempt to tax anyway is a taking without due process of law. Id. It necessarily follows that where the objects of taxation are located in two or more states, then the due process clause requires an apportionment of tax burden so as to avoid multiple taxation without regard to the protections, services and facilities being provided by the taxing states. Standard Oil Co. v. Peck, Tax Commissioner, et al, 342 U.S. 382, 384-85 (1952). Indeed, it is this precept that forms the constitutionally permissible basis for the allocation by formula approach used in unitary tax systems such as California's. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992) ["there must be some definite link, some minimum

connection, between a state and the person, property or transaction it seeks to tax."]

In this case, the specific due process analysis starts with two basic precepts which both parties agree upon. First is that a state may not tax plaintiff's nonbusiness dividends because plaintiff is a foreign domiciliary corporation and such income is only taxable in its state of domicile. JS ¶¶ 1 & 12, see ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307, 315-16 (1982). Second is that a state cannot tax indirectly that which it may not tax directly. (Plaintiff's Proposed Statement of Decision [C.C.P. Section 632], submitted May 2, 1997, p. 6, lines 2-13; Defendant Franchise Tax Board's Proposed Statement of Decision [Cal. Rules of Court, rule 232(c)], submitted May 2, 1997, p. 13, lines 3-8).

It is in the applicability of these two precepts to this case that the parties disagree. Plaintiff asserts that the disallowance of a deduction in the amount of the nontaxable dividends effectively increases the taxable income in California by the amount of the nontaxable dividends and thus is indirectly a tax thereon. Plaintiff contends that this is impermissible given that these dividends are not taxable in California.. Defendant argues that case authorities demonstrate that the disallowance of a deduction to the extent of certain nontaxable income is proper, especially where to do so furthers a legitimate governmental purpose. Defendant's assertion will be discussed first.

Three of the five cases cited by defendant are federal cases dealing with United States tax statutes. None of these cases analyze the questioned statutes in terms of

the due process clause. In Denman v. Slayton 282 U.S. 414 (1931), the Court upheld federal tax statutes which excluded both income on tax exempt state obligations and interest on borrowings used to purchase them. In so doing, the Court rejected the taxpayer's constitutional argument that the subject statutes unconstitutionally discriminated against him. Nowhere in the opinion, however, is the precise constitutional provision supposedly prohibiting such discrimination discussed. In Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934) the Court held that a federal tax statute limiting the deduction of depreciation and other expenses did not violate Art. I, § 9, cl. 4 of the U.S. Constitution, which requires that no direct tax be laid except in proportion to the census. The Court expressly stated that it was not considering any question regarding the Fifth Amendment, which is the Federal Due Process Clause. 292 U.S. at 373. Finally, in United States v. Atlas Life Insurance Co., 381 U.S. 233 (1965) the Court upheld the portion of the Federal Life Insurance Tax Act of 1959 which required an insurance company to allocate a portion of its tax exempt interest income to its tax deductible reserve funds, thereby reducing the amount of otherwise taxable income that could be shifted to the deductible reserve funds. In so doing, it rejected the taxpayer's argument that such requirement was unconstitutional, although their exact constitutional parameters supposedly being infringed were not specified in the opinion.[4]

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[4] The Due Process Clause applicable to the Federal Government is contained in the Fifth Amendment rather than the Fourteenth Amendment. Each due process clause applies separately to its respective governmental level. Warren v.

The remaining two cases cited by the defendant do deal with state tax provisions. The first is First Nat. Bank v. Barstow Cty. Tax Assrs. 470 U.S. 583 (1985), in which the Court upheld a Georgia tax statute which limited the exclusion of tax exempt United States obligations from the calculation of a bank's net worth on a pro rata basis with the liabilities incurred to obtain them. The second case is Missouri *ex rel* Missouri Ins. Co. v. Gehner, 381 U.S. 233 (1930), which the Court in First Nat. Bank v. Barstow Cty. Tax Assrs., supra, held "has no vitality today." 470 U.S. at 591.

The cases cited by the defendant do not provide authority for the constitutional parameters governing the state tax arrangement at issue here. These cases do, however, provide a pattern of analysis which is helpful to the resolution of this case. As was summarized in First Nat. Bank v. Barstow Cty. Tax Assrs., supra: "In sum, ever since Gehner, each time this Court has addressed the scope of the tax exemption for Government obligations, it has concluded that the exemption need not be a total exclusion, but, instead, may be limited by charging tax exempt obligations and interest their fair share of *related* expenses and burdens." Id. at 593 (emphasis added). In other words, the Court has taken a symmetrical view of taxation: income and expenses are paired so that if a

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Governmental National Mortgage Association 611 F.2d. 1229, 1232 (1979;) see Shelly v. Kraemer, 334 U.S. 1, 12 (1948). The *state* fourteenth amendment due process limitations on unitary tax allocations are protections from taxation by a government which is not connected with the activity generating the earnings. Obviously this concept does not apply to a national federal government.

taxpayer need not include certain income in its taxable income, it cannot deduct expenses related to generating that non-included income from its taxable income.

Such logic is precisely what the California Supreme Court recognized in its concern over tax loopholes in Pacific Telephone:

> "Although dividends received by a nondomiciliary like American are not taxable in California, it is not true that such dividends are totally unrelated to California. As pointed out above in connection with the discussion of the possible loophole, a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money. California has a substantial interest in making sure that income attributable to this state is not distorted by the use of the interest expense deduction, and under subsection (b) [of Rev. & T.C. § 24344] the dividends received are only taken into account to offset the interest expense deduction." 7 Cal. 3d at 556.

Although not so articulated by the Court in Pacific Telephone, this analysis would seem to satisfy the constitutional due process requirements that a taxing state must have "some definite link, some minimum connection" with the property it seeks to tax. Allied Signal, Inc. v. Director, Division of Taxation, supra, 768 U.S. at 777. If money were borrowed in California to pay for securities generating income not taxable in California, then California would seem to have a sufficient link to the investment

transaction to close the loophole and prevent windfall deductions for interest expense.

Rev. & T.C. § 24344(b), however, is not so targeted. It disallows interest deductions on a dollar-for dollar basis with non-taxable dividend income without regard to whether or not such interest is *related to* the dividend income. In that regard, it bears a striking similarity to the Georgia tax statute that was originally considered by the United States Supreme Court in First Nat. Bank v. Barstow Cty. Tax Assrs., supra, 470 U.S. 583. As originally presented to the Court, the Georgia statute might have been interpreted to prohibit the exclusion of all tax exempt United States obligations from the calculation of a bank's net worth. Upon that possibility, the Court remanded the case back to the Georgia Supreme Court in order to allow it to interpret its own state statute. On remand, the Georgia Supreme Court "sought to save the statute by construing it to allow a bank to deduct from its net worth 'the percentage of assets attributable to federal obligations'." Id. at 587. It was this reconsidered interpretation that was upheld by the Supreme Court. Id. at 596-97.

Synthesizing the foregoing, it would appear that Rev. & T.C. § 24344(b) runs afoul of defendant's authorities to the extent that it does not permit the deduction of interest expense not related to the generation of the taxpayer's nontaxable dividend income. Put differently, even given the possibility of a legitimate California state interest in closing the loophole recognized in Pacific Telephone, the statute is overly broad in that it goes far beyond such potential legitimate state purpose. This point is underscored in this case because here the parties have

stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any non-unitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the interest exempt dividends.

Accordingly, Rev. & T.C. § 24344(b) results in a taking of plaintiff's property without due process of law and is thus in violation of the Fourteenth Amendment to the United States Constitution..

2. The Commerce Clause

Plaintiff's next argument is that Rev. & T.C. § 24344(b) violates the Commerce Clause of the United States Constitution. Plaintiff's argument is that the dollar-for-dollar offset against nontaxable income applies only to dividends of foreign corporations and is thus a Constitutionally impermissible burden on interstate commerce. Defendant asserts that on its face, the statute doe not call for a different treatment of interest expense of foreign corporations and that at most the statute discriminates against the character of income (i.e. business vs. nonbusiness) rather than upon taxpayer domicile.

The Commerce Clause to the United States Constitution provides that "the Congress shall have the power to regulate Commerce among the several states." U.S. Const., Art. I, § 8, cl. 3. The Commerce Clause has long been interpreted to have a "negative commerce clause" that precludes the states from unjustifiably discriminating against interstate commerce. Oregon Waste Systems,

Inc. v. Department of Environmental Qualifty of Oregon, 511 U.S. 93, 98-99 (1993). This negative commerce clause prohibits economic protectionism, i.e., using regulatory or taxing measures to benefit in-state economic interests by burdening out-of-state competitors. Fulton Corp. v. Faulkner, ___ U.S. ___, 116 S.Ct. 848, 853 (1996).

In the area of state taxation, it is well established that a state might further a legitimate state interest with a taxing scheme that discriminates against interstate commerce, but only where the effects thereof upon interstate commerce are just incidental. City of Philadelphia et al v. New Jersey, et al, 437 U.S. 617, 6623-24 (1978). Without a legitimate state interest being furthered, however, it is clear that a state may not tax a transaction or incident more heavily simply because there is an interstate element to it; such laws are "virtually per se invalid." Fulton Corp. v. Faulkner, supra, at 854; Armco, Inc. v. Hardesty, Tax Commissioner of West Virginia, 467 U.S. 638, 644-46.[5]

Applying these rules to this case, it is clear that Rev. & T.C. § 24344(b) violates the negative commerce clause of the United States Constitution. The starting point in this analysis is whether the provisions requiring that interest deductions be offset against nontaxable income discriminate against foreign taxpayers. The several examples provided by the parties demonstrate that the offset provisions treat two corporations in an identical business

[5] The "virtually per se" language reflects an exception which allows a state to require that an interstate transaction bear economic tax burdens already borne by intrastate transactions. Fulton Corp. v. Faulkner, supra, at 853, and cases cited therein. This exception does not apply in this case.

transaction differently based solely on their states of domicile, which difference results in increased taxes for foreign corporations. See Tables III and IV in Pacific Telephone, supra, at pp.552-53[6]

The defendant asserts that the *tax* in question here is nondiscriminatory. Defendant argues that if anything it is the deductions that distinguish, and those differentiate not on the domicile of the taxpayer but on whether income is nontaxable (hence must be offset against otherwise allowable interest deduction). Such linguistic analysis ignores the impact of the words being dealt with. No matter how one expresses the concept, the amount of tax on a foreign corporation under Rev. & T.C. §24344(b) will be higher than that of a domestic corporation where both have a) the same taxable business income; b) the same interest expense deductions; and c) the same dividend income. The constitutionality of such a result cannot possible be determined by the statutory words used to create it, i.e. whether the discriminatory tax burden was caused by a "tax" or a "reduction of deduction due to nontaxable income". See, for example, Camps Newfound/Owatonna, Inc. v. Town of Harrison, et al, ___ U.S. ___, 97 Daily Journal D.A.R. 6299 (1997), where an exemption for charitable institutions from an otherwise generally applicable state property tax which excluded organizations which operated principally for the benefit of nonresidents was held to violate the negative commerce clause; Darnell &

[6] In addition, there is some support for the view that Rev. and T.C. §24344 was expressly designed to increase taxes on foreign corporations while reducing those of domestic corporations. See Pacific Telephone at p. 554..

Son v. Memphis, 208 U.S. 113 (1908), where Tennessee tax exemptions for in state harvested logs but not out of state harvested logs was deemed an impermissible burden on interstate commerce.

The next step in the analysis would be to determine whether California was furthering a legitimate state purpose which, if identified, might justify the differentiated treatment so long as the impact on interstate commerce was merely incidental. This step does not get off the ground. As is stated in the Due Process discussion above, Rev. & T.C. §24344(b) is overbroad and as applied to this case does not further a legitimate state purpose. As such, it is irrelevant as to whether the impact on interstate commerce is incidental or not.

Therefore, Rev. & T.C. §24344(b), which discriminates against the interstate element of foreign corporation's receipt of nontaxable dividend income outside of California violates the Commerce Clause of the United States Constitution.

3. The Equal Protection Clause

Plaintiff next agues that Rev. & T.C. § 24344(b) violates the Equal Protection Clause of the United States Constitution by impermissibly creating an arbitrary and irrational classification based on the domicile of a corporate taxpayer. Defendant asserts that the language of the statute contains no classification based on domicile and, in any event, the statutory scheme is rational in that it is designed to allow deductions of only expenses which correspond to income taxable in California.

In the area of state taxation, the Equal Protection Clause[7] precludes a state from imposing more onerous taxes or other burdens on foreign corporations than those imposed on domestic corporations, unless the discrimination between foreign and domestic corporations bears a rational relationship to a legitimate state purpose. Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869, 875 (1985) [holding that the promotion of domestic industry is not a legitimate state purpose under due process analysis and rejecting Alabama's other purported interest in its higher tax rate for out of state insurers]; Williams v. Vermont, 472 U.S. 14, 23 (1985) ["A state may not treat those within its borders unequally solely on the basis of their different residences or states of incorporation."].

Applying this analysis to the present case, it is clear that Rev. & T.C. § 24344(b) violates the Equal Protection Clause. Defendant asserts that the legitimate state interest being furthered here is "to allow a deduction of only those expenses relating to an item of income which the state is not barred from taxing." Defendant Franchise Tax Board's Reply Brief, filed herein on March 13, 1997, p. 19-20. As is discussed above, however, Rev. & T.C. § 24344(b) is not so limited and precludes interest deductions to the extent of nontaxable income *irrespective of whether those deductions are related to the nontaxable income.* Since this provision applied unequally to domestic corporations and foreign corporations because only the

[7] The Equal Protection Clause provides "..nor shall any State...deny to any person within its jurisdiction the equal protection of the laws." United States Constitution, Amendment 14, Sec. 1.

dividend income of the latter are nontaxable in California, the purported state purpose is discriminatory and not rationally related to a legitimate state purpose. As such it violates the Equal Protection Clause of the United States Constitution.[8]

CONCLUSION

Rev. & T.C. § 24344(b) violates the Due Process, Commerce and Equal Protection Clauses of the United States Constitution insofar as it allows for a dollar-for-dollar offset of otherwise deductible interest expenses with nontaxable dividend income of foreign corporate taxpayers. Accordingly, the taxes and interest at issue herein were impermissibly imposed and collected. Plaintiff is therefore entitled to Judgment for $2,258,020.44 plus interest from May 2, 1997 as calculated under Rev. & T.C. § 19391.

Either party may on or before June 20, 1997 file and serve any objections or proposals hereto. Plaintiff shall prepare a proposed form of Judgment, submit it to the defendant for approval as to form, and present it to the Court on or before June 20, 1997.

Dated: June 6, 1997

Richard A. Kramer
Judge of the Superior Court

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[8] Defendant's further argument that the language of the statute does not discriminate against foreign corporations is rejected in light of the effect of the statute, as is discussed above.

SUPERIOR COURT OF THE STATE OF CALIFORNIA
FOR THE CITY AND COUNTY OF SAN FRANCISCO

DEPARTMENT: 17

HUNT-WESSON, INC., Plaintiff(s),

v.

FRANCHISE TAX BOARDD, Defendant(s).

CASE NO. 976628

CERTIFICATE OF SERVICE BY MAIL (CCP 1013a(4))

I, Tatsuo Maruyama, a deputy clerk of the Superior Court for the City and County of San Francisco, certify that:

1) I am not a party to this action;

2) On June 6, 1997, I served the attached;

PROPOSED STATE OF DECISION

by placing a copy thereof in a sealed envelope, addressed as follows:

CHARLES J. MOLL, III, ESQ.
EDWIN P. ANTOLIN, ESQ.
MORRISON & FOERSTER
425 MARKET ST.
SF., CA. 94105

DAVID LEW, Deputy Atty General
STATE OF CALIFORNIA
DEPARTMENT OF JUSTICE
ATTORNEY GENERAL'S OFFICE
50 FREMONT ST. STE. 300
SF., CA. 94105

and,

3) I then placed the sealed envelope in the outgoing mail at 633 Folsom Street, San Francisco, Ca. 94107 on the date indicated above for collection, attachment of required prepaid postage, and mailing on that date following standard court practices.

Dated: JUNE 6, 1997

ALAN CARLSON, Clerk

BY: Tatsuo Maruyama, Deputy
Tatsuo Maruyama
Clerk in Department 17

APPENDIX C

SECTIONS OF BANK AND CORPORATION TAXES

§ 24344. Interest

(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

§ 24402. Dividends received by corporations

Dividends received during the income year declared from income which has been included in the measure of the taxes imposed under Chapter 2 [commencing with § 23101] or Chapter 3 [commencing with § 23501] of this part upon the taxpayer declaring the dividends.

ARTICLE 2

§ 25120. Definition of terms used in "this act"

As used in Sections 25120 to 25139, inclusive, which shall hereafter be referred to as "this act," unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

§ 25121. Income taxable both within and without state: Allocation and apportionment

Any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its net income as provided in this act.

§ 25126. Interest and dividends allocable to state

Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

§ 25128. Formula for apportioning business income to state

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

§ 25129. Formula for determining property factor

The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year.

§ 25132. Formula for determining payroll factor

The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year.

§ 25134. Formula for determining sales factor

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year.

APPENDIX D

[LOGO]

BILL LOCKYER — *State of California*
Attorney General — *DEPARTMENT OF JUSTICE*

1515 CLAY STREET, 20TH FLOOR
OAKLAND, CA 94612-1413

Public: (510) 622-2100

Facsimile: (510) 622-2121
(510) 622-2227

January 4, 1999

Honorable William R. McGuiness, Presiding Justice
Honorable Carol A. Corrigan, Associate Justice and
Honorable Herbert W. Walker, Associate Justice
Court of Appeal of the State of California
First Appellate District, Division Three
303 Second Street, Suite 6005
San Francisco, California 94107

RE: *Hunt Wesson, Inc. v. Franchise Tax Board*
Court of Appeal No. A079969,
Superior Court No. 976628

Dear Presiding Justice McGuiness,
Associate Justice Corrigan
and Associate Justice Walker:

This Court issued its unpublished opinion in this case on December 11, 1998. Appellant Franchise Tax Board of the State of California, respectfully requests that the Court's decision be published pursuant to California Rules of Court, Rule 976. The decision meets the publication criteria, because it resolves an apparent conflict in the law, it involves a legal issue of continuing public interest, and makes a significant contribution to legal

literature by reviewing the judicial history of an important tax statute.

The question answered in the *Hunt-Wesson* case is whether Revenue and Taxation Code Section 24344(b) is constitutional. The constitutionality of a section of the Revenue and Taxation Code is of great significance to taxpayers and the state. Over 40,000 corporations file returns which report their activities both within and without California. These corporations pay over 70% of the bank and corporation tax collected by California. Each of these corporations has the potential to have income which is apportioned by formula and income which is not apportioned by formula so that the amount of interest expense and the manner in which it will be taken into account is governed by Section 24344(b). Section 3.5 of Article III of the California Constitution requires the Franchise Tax Board, an administrative agency, to enforce a statute unless it is declared to be unconstitutional by an appellate court. The Franchise Tax Board has enforced, and will continue to enforce, Section 24344(b) of the California Revenue and Taxation Code in spite of claims by many corporate taxpayers that it is unconstitutional. Publication of the opinion in this case will dispel the uncertainty that exists regarding the constitutionality of Section 24344(b) for many corporations and will defer additional litigation of this question.

The California Supreme Court in *Pacific Tel. & Tel. Co. v. Franchise Tax Board* (1972) 7 Cal.3d 544, construed Section 24344(b), which speaks to the assignment and deductibility of interest expense. The California Supreme Court held that it did not constitute a tax upon dividends that California could not include within the base used to

measure the bank and corporation tax which would have been unconstitutional under decisions of the United States Supreme Court. It did not directly address the question of whether Section 24344(b) was constitutional under the Constitution of the United States.

The *Hunt-Wesson* opinion directly addresses the issue of constitutionality of Section 24344(b). There are a number of other cases, pending at the administrative level, where the question of the constitutionality of Section 24344(b) has been raised. Publication of the opinion in *Hunt-Wesson* will lead to the resolution of these cases and forestall additional litigation.

The opinion of the California Supreme Court in *Pacific Tel. & Tel. Co. v. Franchise Tax Board* was issued in 1972. A substantial period of time has passed since that opinion was issued. The years involved in *Pacific Telephone* predate the adoption of the Uniform Division of Income for Tax Purposes Act, Sections 25120 et seq. (UDITPA) of the Revenue and Taxation Code, which is now the operative law for determining whether income is subject to apportionment by formula or not. The opinion of this court in *Hunt-Wesson* provides certainty that Section 24344(b) operates in conjunction with UDITPA. In addition, the United States Supreme Court has issued a number of decisions discussing whether particular state tax statutes are discriminatory under various clauses of the United States Constitution during the intervening years. The relevance of those decisions, and in particular *Fulton Corp. v. Faulkner* (1996) 516 U.S. 325, is discussed in the opinion and provides needed guidance to both taxpayers and California's tax administrators.

Furthermore, the opinion in *Hunt-Wesson* discusses the relationship between *Fulton* and Section 24402 of the Revenue and Taxation Code. Though this question was not directly at issue in *Hunt-Wesson*, the court's discussion provides insight and guidance to both taxpayers and the Franchise Tax Board with respect to an issue that is currently being reviewed in the administrative process.

Accordingly, appellant submits that the *Hunt-Wesson* opinion meets the criteria for publication under California Rules of Court, Rules 976(b)(2), 976(b)(3) and 976(b)(4), and respectfully requests its publication.

Sincerely,

BILL LOCKYER
Attorney General

/s/ David Lew
DAVID LEW
Deputy Attorney General

APPENDIX E

First Appellate District, Division Three, No. A079969
S076104

IN THE SUPREME COURT OF CALIFORNIA

HUNT-WESSON INCORPORATED, Respondent

v. (Filed MAR. 24, 1999)

FRANCHISE TAX BOARD, Appellant

Respondent's petition for review DENIED.
The request for an order directing publication of the opinion is denied.

Kennard, J., is of the opinion the petition for review should be granted.

GEORGE
Chief Justice